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Incentives and group identity

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ABSTRACT

This paper investigates in a principal–agent environment whether and how group membership influences the effectiveness of incentives and when incentives can have "hidden costs", i.e., a detrimental effect. We show experimentally that in all interactions control mechanisms can have hidden costs for reasons specific to group membership. In within-group interactions control has detrimental effects because the agent does not expect to be controlled and reacts negatively when being controlled. In between-group interactions, agents perceive control more hostile once we condition on their beliefs about principals' behavior. Our finding contributes to the micro-foundation of psychological effects of incentives.

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1. Introduction

An important premise in agency theory is the power of incentives: without proper incentives, agents would not put in enough effort and would shirk substantially. As a consequence, principals need to use incentives and control systems in order to make agents perform. While incentives do increase effort in certain settings (e.g., Lazear, 2000), they can also have detrimental effects, i.e., individuals put in *less* effort in the presence of monetary incentives than without (for reviews of the literature, see Fehr and Falk, 2002; Frey and Jegen, 2001; Gneezy et al., 2011). Control as one particular form of incentive can be particularly problematic as results by Falk and Kosfeld (2006) indicate. The implementation of a control mechanism that forces agents to put in at least some effort can have substantial "hidden costs" leading to lower effort than if agents are not controlled by the principal.[1] While there is growing evidence that incentives can be detrimental in principal–agent situations, the *conditions* when incentives turn detrimental are less understood.

This paper investigates whether "hidden costs of incentives and control" are particularly relevant when the principal and the agent have a close relationship (as argued Dickinson and Villeval, 2008; Frey, 1993). Detrimental effects of incentives and control mechanisms might be restricted to interactions among friends, family members or in-group members as they

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[1] Similar detrimental effects of control and incentives are observed in a number of other experimental studies (e.g. Fehr et al., 2007; Fehr and Rockenbach, 2003; Fehr and List, 2004; Gächter et al., 2010). And hidden benefits of delegation (i.e., the flipside of control) are also observed (Charness et al., 2012).

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are more likely to be perceived by the agent as distrust and a violation of a psychological contract (e.g. Ellingsen and Johannesson, 2008; Fehr and Falk, 2002; Sliwka, 2007; von Siemens, 2013). Many examples of hidden cost of incentives refer, in fact, to interactions within-group, e.g. negative effect of incentivizing one's child to help in the house (Frey and Jegen, 2001), helping a friend move for free or for pay (Heyman and Ariely, 2004). However, in many situations incentives are used *not* within-group but in between-group interactions. For example, many principal–agent relationships are between firms, i.e., buyers and suppliers. Even within firms, the principal often belongs to and identifies with a different and very salient team or group: the management (white collar) controls the workers (blue collars) or provides incentives to the sales force. It is well known that in such between-group interactions, trust is lower to begin with (e.g. Chen and Li, 2009; Falk and Zehnder, 2013; Fershtman and Gneezy, 2001) and incentives might be less detrimental as agents do not expect their out-group principals to be trusting. If the incentive effect is less detrimental in between-group interactions, then the effect might be less relevant in a situation in which agents do not identify with the same group as the principals.

We test the impact of group identity on the effectiveness of incentives in an experiment à la Falk and Kosfeld (2006) in which all participants belong to one of two different groups (the group manipulation is implemented similar to Chen and Li, 2009). Principals have to decide whether or not they want to control their agent by setting a minimum transfer level. Agents then decide on transfers. Our experiment is able to replicate both that a) control can be detrimental and reduce transfers and that b) group membership leads to substantial in-group bias, i.e., agents provide higher transfers for in-group principals. More importantly, our setting allows analyzing whether the "hidden cost of control" are group-specific, i.e., whether control is perceived differently in within-group and between-group matchings.

The results show that hidden costs of control are as strong in between-group matchings as in within-group matchings. But while the overall effectiveness of incentives seems not to depend on the social distance between principal and agents through joint group identity, the mechanisms for how incentives are perceived are group-specific. In within-group interactions "hidden costs of control" occur because agents expect the principal not to control. When principals control nevertheless, agents reduce their transfers significantly as a reaction. If the agent and the principal do not share the same group, however, the mechanism is different: Keeping agents' beliefs about the principal's behavior constant, agents perceive control more hostile in a between-group matching. This "hostility effect" is consistent with previous findings Chen and Li (2009) and Götte et al. (2012a), who show that when minimal groups are artificially generated, punishment for misbehavior is stronger in between-group than in within-group interactions.[2]

Our results make two important contributions to the literature: First, our paper contributes to the discussion of the impact of group identity in organizations. Akerlof and Kranton (2005) stressed the importance of group identity for organizational design and incentive schemes – introducing a long research tradition in social psychology to economics.[3] While there is a growing literature in economics on the effects of group identity on individual behavior (e.g. Bernhard et al., 2006; Charness et al., 2007; Chen and Chen, 2011; Chen and Li, 2009; Fershtman and Gneezy, 2001; Göette et al., 2006, 2012a, 2012b; Sutter, 2009), there are few papers that investigate how social interactions (within or across firms) affect the efficacy of incentives and control schemes. Bandiera et al. (2009, 2010) show how social connections *among agents* affect the effectiveness of different incentive schemes. Our paper focuses on the effectiveness of principal's control without lifting anonymity as in Dickinson and Villeval (2008), who study the impact of monitoring.[4] Moreover, it is related to Riener and Wiederhold (2012) who investigate how social distance affects effort choices. Our results show that incentive schemes can have detrimental effects not only in principal–agents relationship with close social ties. Incentives and control schemes are perceived very differently in between vs. within-group matchings indicating that group membership in principal–agent relationships is important.

Secondly, we contribute to the literature in economics on psychological effects of incentives. While a number of previous papers show that incentives can have "hidden costs" (for a review, see Gneezy et al., 2011), relatively little is known about the conditions under which incentives or control mechanisms are more likely to have detrimental effects. Our paper shows that 'situational' factors critically affect how incentives are perceived, and as a result, when they are more likely to work as predicted by traditional agency theory and when not. In the end, in both between- and in within-group matchings the implementation of a control mechanism has "hidden costs", but for different reasons. These different, group-specific reasons contribute to a micro-foundation of psychological effects of incentives.

The paper proceeds as follows: in Section 2 we present the experimental design. Section 3 discusses our behavioral hypotheses based on a simple model that illustrates the different effects group identity can have on incentives. Section 4 presents the results and Section 5 concludes.

[2] When real groups are considered, however, as in Bernhard et al. (2006), Götte et al. (2006), individuals punish violators of social norms harsher in between-group interactions only if the victim of the violation belongs to their own group.

[3] In the management literature, identification with a firm is also been argued to be an important aspect of firm's performance through improving coordination and cooperation (e.g. Kogut and Zander, 1996).

[4] They generate interpersonal relationships between principal and agents by removing subject anonymity, introducing subjects to one-another and allowing them to engage in five-minutes of face-to-face interactions. They find that monitoring incentives are no more efficient when anonymity is lifted and social exchange between principal and agent is allowed.

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